

What Remedies Do Midstream Companies Have with Production Shortfalls of Contracted E&P Volumes?

Upstream Dilemmas Require Midstream
Responses

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How did we get here?

- Oil and gas industry is, and always has been, extremely creative from a financial perspective
- Upstream - 1/3 for a 1/4
- Need to construct gathering facilities/systems to deliver product to market
 - Lease terms
 - JOA
- Need to finance such construction
- Create a revenue stream to service the debt
- Segregate liabilities between E&P and G&P
- Different owners in each of E&P and G&P
- Different types of investors in each of E&P and G&P
 - Different risk tolerances
 - Desire to direct revenue streams (business and personal)

Further context

- What does “gathering and processing” mean?
- What does “midstream” mean?
- Absence of “black letter” law
- Facts in each case are different
- Each “system” is different
 - Wellhead
 - Lease boundary
 - Contract Area/JOA
 - Easements/ROWs
 - Various diverse combinations of the above

Further context

- Gathering and Processing Agreements are different
 - Different parties with different needs
 - Address different situations on the ground
- Gathering and Processing Agreements within a system are different
- Relevant “Midstream“ Agreements might address:
 - Gathering
 - Processing
 - Transportation/Transmission
 - Any combination

E&P Bankruptcy

- In re Sabine Oil & Gas Corporation, et. al. (Case No. 15-11835) (Bankr. S.D.N.Y.)
- In re Quicksilver Resources, Inc., et. al. (Case No. 15-10585) (Bankr. D. Del.)
- Magnum Hunter

Relevant Contract Provisions

- Dedication of Reserves
 - Produced Minerals
- Acreage Commitment
- Minimum Volume Commitment
- Jurisdiction

Why Should We Care?

- E&Ps in bankruptcy and their secured creditors want to maximize their value
 - Debt for equity swap
 - Possible rejection of contract
 - Loss of value in contract
 - Loss of revenues
 - Transportation fees
 - Processing fees
 - Minimum volume commitment
 - Loss of subject acreage

Executory Contracts

- Covenants running with the land are not property of the E&P's estate and cannot be rejected
- A service contract creating a contractual interest can be rejected (prepetition general unsecured claim)

In re Sabine Oil & Gas Corporation, et. al.

- Sabine did not seek to reject all of its gathering agreements
- Nordheim Agreements
 - Agreed to “dedicate” to the “performance” of the agreement all of the gas produced from a designated area and deliver such gas to Nordheim
 - Nordheim agreed to
 - Gather, treat, dehydrate, and re-deliver gas to Sabine
 - Construct gathering system
 - Minimum annual volume commitment/deficiency payment
 - Agreement itself is a covenant running with the land
 - Separate conveyance of land for facilities

In re Sabine Oil & Gas Corporation, et. al.

- HPIP Agreements
 - Agreed to “dedicate” to the “performance” of the agreement certain leases owned by Sabine and the oil, gas, and water produced from the wells located on the land subject to those leases and deliver that oil, gas, and water to HPIP.
- HPIP agreed to:
 - Construct, operate, and maintain gathering facilities to provide certain services with respect to the products delivered by Sabine
 - Handling Agreement addressed disposal services for water and acid gas

In re Sabine Oil & Gas Corporation, et. al.

- Debtors Satisfied the Standard for Rejection of the Agreements
 - Permit the trustee or DIP to use valuable property of the estate and to renounce title to and abandon burdensome property
 - Determine if assuming or rejecting a contract would be a good business decision or a bad one
 - Interests of the debtor and its estate are paramount
 - Adverse effects on the non-debtor contract party are irrelevant
 - Would a reasonable business person make a similar decision under similar circumstances
 - Agreements are unnecessarily burdensome
 - Will enter into new gathering agreements with other gatherers on terms more favorable to the Debtors
 - No argument that Debtors decision was result of “bad faith, whim or caprice.”
- Nordheim’s Bankruptcy Court oral argument
 - Legal limitation on Court’s authority in the context of the Motion

In re Sabine Oil & Gas Corporation, et. al.

- Court concludes that it cannot decide substantive legal issues, including whether the covenants at issue run with the land, in the context of a motion to reject, unless such motion is scheduled simultaneously with an adversary proceeding or contested matter to determine the merits of the substantive legal disputes related to the motion.
- Federal Rules of Bankruptcy Procedure 6006 and 9014 are trumped by Second Circuit's decision in *Orion* – a summary proceeding to efficiently review the trustee's or debtor's decision
- Not the time or place for prolonged discovery or a lengthy trial with disputed issues
- No procedural clarity or consensus
- Must rule on the Motion “without deciding in a binding way the underlying legal dispute with respect to whether the covenants at issue run with the land.”
- Finds that decision to reject is “a reasonable exercise of business judgment.”

In re Sabine Oil & Gas Corporation, et. al.

- Covenants At Issue Do Not Run With The Land
 - Real covenant or equitable servitude
 - Under Texas law, a covenant runs with the land when:
 - It touches and concerns the land
 - It relates to a thing in existence or specifically binds the parties and their assigns
 - It is intended by the original parties to run with the land
 - The successor to the burden has notice
 - Horizontal privity
 - “simultaneous existing interests or mutual privity” between the original covenanting parties as either landlord and tenant or grantor and grantee.”
 - Requires some additional transactional element to their relationship other than the covenant usually in the form of a reservation of interest (Energytec)
 - Not present here

In re Sabine Oil & Gas Corporation, et. al.

- Mineral estate consists of:
 - Right to develop (the right of ingress and egress)
 - Right to lease (executive right)
 - Right to receive bonus payments
 - Right to receive delay rentals
 - Right to receive royalty payments
- Does not include:
 - Right to transport and gather produced gas
 - Query: How valuable are the some of the other rights without gathering, transporting and processing?

In re Sabine Oil & Gas Corporation, et. al.

- Covenants do not satisfy the “touch and concern” prong
 - Does the covenant affect “the nature, quality or value of the thing demised, independently of collateral circumstances, or if it affected the mode of enjoying it?”
 - Are the promisor’s legal relations in respect of the land in question lessened – his legal interest as owner rendered less valuable by the promise ... [and] if the promisee’s legal relations in respect to the land are increased – his legal interest as owner rendered more valuable by the promise.
 - Arguable that the benefit requirement has been abandoned. (5th Cir.)
 - The covenant “must still affect the owner’s interest in the property or its use in order to be a real covenant.”
 - Covenants concern only Sabine’s interests in the produced hydrocarbons which are personal property under Texas law.
 - Contracted-for services
 - Do not have a direct impact upon the real property from which those products were produced (Query: What is the value of the reserves if the product cannot get to market?)

In re Sabine Oil & Gas Corporation, et. al.

- Energytec – right to consent to assignment was a clear burden
 - Secured by a lien on the entire system
- Sabine lienholders did not approve a conveyance of any interest in the land subject to the liens, and they were not informed of any interest being created in the properties.
- Nordheim’s gathering fee not as directly tied to the promisor’s land as was the case in Energytec.

Conclusion and Take-Aways

- Court did not make any final determination as to whether the covenants at issue run with the land or as to any substantive legal issue other than granting authority to reject the contracts under 365(a)
- Rejection must be reasonable under “business judgment” rule
 - What terms are not “market?”
- Pursue evidence of bad faith, whim, or caprice
- Is perfection of liens a possibility?
- What are realistic alternatives for gathering, transport, processing?
 - Common carrier/common purchaser status/tariff/non-discrimination

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